

## Auditing the cash flow statement (Lecture A887 – 9.15 minutes)

*The frequency of questions raised in relation to cash flow statements (11% of companies reviewed, 2022/23: 8%) remains disappointingly high in our top ten. It also remains one of the most common reasons for companies restating their prior year financial statements as a result of our enquiries, with the number restating their cash flow statement more than doubling to 16 compared within seven last year.*

FRC Corporate Reporting Review 2024

Excerpt from 2023/24

As can be seen from the comments raised by the Financial Reporting Council (FRC) Corporate Reporting Review Panel (CRRP), cash flow statements are in the 'top ten' of the most common deficiencies identified in its review of financial statements. While the CRRP's focus is that of public interest entities and listed entities all reporting under IFRS Accounting Standards, the comments raised by the FRC can be taken on board by preparers and auditors of financial statements prepared under UK and Ireland GAAP.

As noted earlier in the course, the cash flow statement (or 'statement of cash flows' as it is referred to in FRS 102, Section 7 *Statement of Cash Flows*) is one of the primary financial statements. This means that it is given no more, and no less, prominence than the other primary statements (the profit and loss account, balance sheet, other comprehensive income statement and statement of changes in equity).

A concern of file reviewers and professional bodies during their reviews of audit files is that a review will often reveal that no audit work (or very little audit work) has been carried out on the cash flow statement, despite it being a primary financial statement and listed as one of the statements that has been audited in the auditor's report. Often there is a misconception that if the cash flow statement balances and audit work has been carried out on the profit and loss account, other comprehensive income statement, balance sheet and statement of changes in equity, then the cash flow statement must, by default, be correct. This is, however, a reckless approach as the cash flow statement could still be materially misstated.

### **Objective of the cash flow statement**

Generally, the cash flow statement provides an insight as to how an entity has generated and spent cash. However, it is also used to:

- assess the entity's ability to generate future cash flows;
- assess the entity's ability to pay dividends and to meet obligations (e.g. payment of interest and capital to lenders);
- understand the differences between the measure of profit used and the net cash flow from operating activities; and

- assess the cash and non-cash investing and financing activities during the period.

Whilst fraud at the financial statement level is usually associated with profit and loss account and balance sheet accounts, fraud in the cash flow statement can exist and can be potentially significant. This could happen, for example, if the entity boosts operating cash flows by shifting cash inflows from financing activities into it or shifting operating cash outflows into financing or investing activities.

The audit of cash and cash transactions is critical because cash is the primary target of employee (and management) fraud.

Challenging the treatment of some unusual cash flows in the cash flow statement demonstrates that the audit team has exercised professional scepticism (provided, of course, this is adequately documented in the audit working papers).

#### **Example – Assets acquired under finance leases**

During the year to 30 September 2024, a company acquired a large amount of heavy-duty machinery via finance leases. The audit team had obtained sufficient appropriate audit evidence to confirm that each lease classification as a finance lease was correct and there was also sufficient appropriate audit evidence obtained that the entity had correctly accounted for these finance leases.

The cash flow statement included the value of additions to property, plant and equipment within the investing activities section of the cash flow statement and this agreed to the property, plant and equipment (PPE) note that provides a breakdown of cost, depreciation and net book value.

The problem with the finance lease transactions is in the cash flow statement. The total additions to PPE include assets acquired under finance leases. These are not cash outflows. The cash outflows in respect of finance leases are the amounts paid to reduce the principal amount of the lease liability (shown as an investing cash flow) and actual amounts of interest paid, rather than the interest calculated using the effective interest rate.

An adjustment to the cash outflows for the acquisition of PPE is needed as well as a corresponding adjustment to the investing cash flows for capital repayments and in the operating cash flows for actual interest paid as well as the non-cash impact of the effective interest charged to profit and loss on the finance leases, all of which should tie back to the audit work carried out on the lease liabilities.

As you can see, the scope for errors in the cash flow statement is high when it comes to issues such as finance leases and bank loans. Quite often, accounts production software systems will automatically calculate certain values based on the movement between the current year's trial balance and the prior year one. However, the system may not necessarily present them properly in the cash flow statement.

For auditors, the important point to bear in mind here is that while a cash flow statement might, on the face of it, balance, when the cash flows are subject to audit procedures, those procedures may well reveal errors in the cash flow statement.

### **Audit procedures for the cash flow statement**

For most audited entities, the cash flow statement will be automatically calculated – usually from movements between the current year and prior year trial balance. However, it is important that the auditor exercises professional scepticism throughout the audit and, where the cash flow statement is concerned, keeps in mind that there could be manipulation of the figures presented in the cash flow statement (e.g. to boost net cash inflows from operating activities or even to turn net cash outflows from operating activities into net cash inflows from operating activities).

As noted in the example above, the auditor must also bear in mind that cash flows may be misstated, even though the statement itself balances.

Typical audit procedures for the cash flow statement include the following (note, the list below is not comprehensive):

- Agree and reconcile all amounts in the cash flow statement to amounts that appear elsewhere or to the auditor's working papers (e.g. tax paid and interest paid amounts to bank statements). Ordinarily, the auditor would expect to see an adjustment in the operating cash flows section for the non-cash impact of the effective interest charge taken to profit or loss when the entity has applied the amortised cost method.
- Agree the reconciliation of profit (loss) to net cash flow from operating activities to other areas of the financial statements, e.g.:
  - the measure of profit (loss) to the profit and loss account;
  - depreciation charge to the fixed assets lead schedule;
  - gain or loss on disposal of fixed assets to the reperformance of the disposal account; and
  - movements in working capital to the balance sheet items;
- Reperform the cash flow statement from the audited profit and loss account, balance sheet and statement of changes in equity to ensure accuracy.
- Cast the cash flow statement for mathematical accuracy.
- Confirm that amounts reported in investing and financing activities have been correctly classified and that the amounts are reasonable (e.g. calculating the capital amount of loan repayments agrees to the recalculation of the loan liability at the year end).
- For foreign currency cash flows, ensure these have been translated using the exchange rate at the date of the cash flow (or an average exchange rate if exchange rates have not

fluctuated significantly during the reporting period) – where average rates are used, recalculate the average rate and agree this to the one used.

- For unrealised gains and losses arising from changes in exchange rates, recalculate the effect of the exchange rate change on cash and cash equivalents held in a foreign currency and ensure this has been presented separately from cash flows from operating, investing and financing activities.
- Agree non-cash transactions to supporting documentation and ensure they have been excluded from the cash flow statement (e.g. conversion of debt to equity or the acquisition of a subsidiary via a share-for-share exchange).
- Review the disclosures for non-cash transactions for adequacy. The use of an up-to-date disclosure checklist is strongly advised here.
- Agree the components of cash and cash equivalents to the balance sheet including the components of the reconciliation of amounts presented in the cash flow statement to the equivalent items presented in the balance sheet.
- Agree the analysis of changes in net debt to supporting information and ensure sufficient detail has been shown to enable users to identify balances where several balances (or parts therefore) in the balance sheet have been used.

### **Errors identified by the FRC**

The FRC have raised queries where its review has identified:

- the purchase of non-controlling interests classified as investing, rather than financing activities;
- contingent remuneration paid to employees of an acquired business classified as investing, rather than operating, activities;
- cash flows from derivatives classified inconsistently with the transactions they related to, such as payments on swaps used to hedge debt classified as investing activities, with the cash flows related to the hedged debt classified as financing activities;
- the settlement of debt related to the acquisition of a subsidiary classified as an investing cash flows; and
- the repayment of a loan from a group undertaking classified as an operating, rather than financing, cash flows.

### **Requests for further information**

The FRC have requested further information when:

- There appeared to be material inconsistencies between amounts or descriptions in the cash flow statement and other information in the report and accounts, for example,

when cash flows in relation to an acquisition of a subsidiary did not agree to the acquisitions note.

- Gross or net presentation of cash flows appeared inconsistent with other disclosures, such as a refinancing exercise when gross cash inflows and outflows had been disclosed, or when payments to group undertakings in cash pooling arrangements had been offset against receipts from group undertakings.
- It appeared that non-cash transactions were included in the cash flow statement, for example when a subsidiary had been acquired via a share-for-share exchange or when right-of-use assets had been acquired under leases.
- Descriptions of items in the cash flow statement did not appear to accurately reflect the nature of the amounts.

### **Queries raised with companies**

The FRC raised queries with companies when:

- It was unclear why amounts invested in certificates of deposit had been included in cash and cash equivalents.
- The reason for excluding restricted cash balances from cash and cash equivalents was not clear from the disclosures given.
- A bank overdraft was included within cash and cash equivalents in the parent company cash flow statement, but not in the consolidated cash flow statement.

### **What auditors should be checking**

It is not possible to provide a prescriptive set of audit procedures because every audit is different. However, where the cash flow statement is concerned, auditors should (at the very least) be checking:

- The classification of cash flows, as well as cash and cash equivalents, comply with relevant definitions and criteria in FRS 102 and cash flows are not inappropriately netted in both the group and (where applicable) the parent company's cash flow statement. The relevant procedures and the conclusions drawn must be adequately documented on the audit file.
- Amounts and descriptions of cash flows are consistent with those reported elsewhere in the accounts. Keep in mind the potential for error where finance leases have been entered into during the year.
- Non-cash investing and financing transactions are excluded from the statement and disclosed elsewhere if material.

Do not rely on automated accounts production software to get this completely right as often the cash flow statement is the one primary statement that will invariably require user-input to arrive at the correct values to be included in the statement and related notes.